REPORT OF EXAMINATION
OF THE

ZENITH INSURANCE COMPANY

AS OF
DECEMBER 31, 2005

Participating State
and Zone:

California

Filed November 30, 2006

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Los Angeles, California
November 1, 2006

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Gary L. Smith
Secretary, Zone IV-Western
Director of Insurance
Department of Insurance, State of Idaho
Boise, Idaho

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Director and Commissioner:

Pursuant to your instructions, an examination was made of the

ZENITH INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 21255 Califa Street, Woodland Hills, California 91367.

## SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

The examination was conducted concurrently with the examination of the Company's wholly-owned subsidiary, ZNAT Insurance Company.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; business in force by states; loss experience; accounts and records; and sales and advertising.

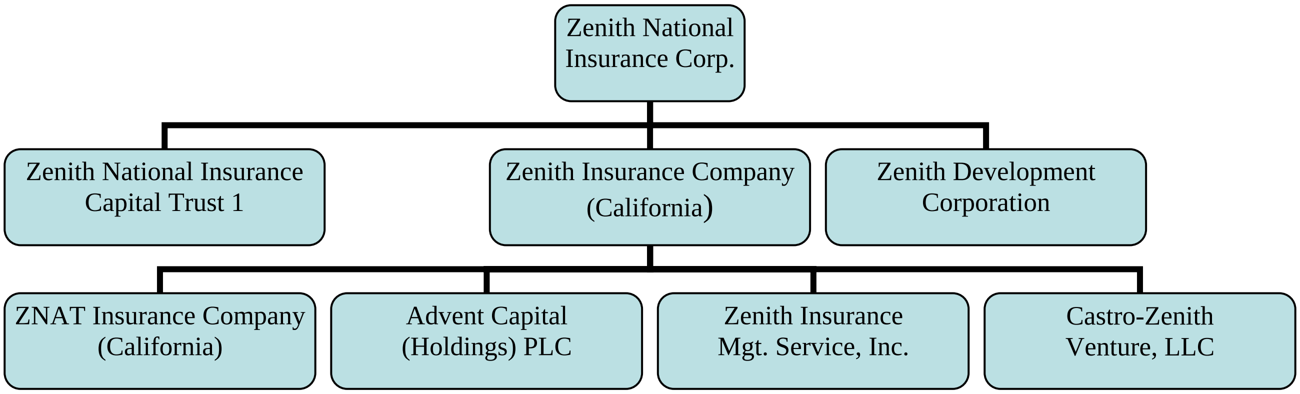
## COMPANY HISTORY

In 2002 and 2003 the Zenith National contributed a total of $92,462,890 in cash to the Company. Also, during the period covered by this examination, the Company paid dividends to its stockholders totaling $60 million.

## MANAGEMENT AND CONTROL

As of the prior examination date, Fairfax Financial, through its subsidiaries, owned 42% of the Company's parent, Zenith National Insurance Corporation's (Zenith National), common stock. At December 31, 2005, companies controlled by Fairfax Financial owned 3.8 million or 10.3% of the total outstanding shares of common stock of Zenith National. On February 7, 2006 Fairfax Financial sold all of the 3.8 million shares and no longer owns shares of Zenith National common stock.

The following abridged organizational chart, which is limited to the Company's parent along with its subsidiary insurance companies, depicts the Company's relationship within the holding company system:




Each of the above entities is 100% owned by its parent except for Advent Capital (Holdings), PLC which is 10% owned by the Company and Castro – Zenith Venture, LLC which is 50% owned by the Company.

Management of the Company is vested in a nine-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2005 follows:

Directors

| Name and Residence | Principal Business Affiliation |
|---|---|
| Stanley R. Zax<br>Beverly Hills, California | Chairman of the Board and President<br>Zenith National Insurance Corp. |
| Max M. Kampelman<br>Washington, District of Columbia | Attorney, of Counsel<br>Fried, Frank, Harris, Shriver, and Jacobson, LLP |
| Robert J. Miller<br>Las Vegas, Nevada | Attorney,<br>Principal Dutko Worldwide |
| Leon E. Panetta<br>Carmel Valley, California | Founder and Director<br>The Leon & Sylvia Panetta Institute for Public Policy |
| Catherine B. Reynolds | Chairman and Chief Executive Officer |

| Name and Residence | Principal Business Affiliation |
|---|---|
| McLean, Virginia | The Catherine B. Reynolds Foundation |
| William S. Sessions<br>Washington, District of Columbia | Attorney<br>Holland and Knight LLP and Security Consultant |
| Alan I. Rothenberg<br>Beverly Hills, California | Attorney; Chairman, First Century Bank;<br>Retired Partner, Latham & Watkins LLP |
| Gerald Tsai, Jr.<br>New York, New York | Management of Private Investments |
| Michael Wm. Zavis<br>Northbrook, Illinois | Attorney, Retired Founding Partner<br>Katten Muchin Zavis Rosenman |

Principal Officers

| Name | Title |
|---|---|
| Stanley R. Zax | Chairman of the Board |
| Jack D. Miller | President |
| Davidson M. Pattiz | Executive Vice President |
| Keith E. Trotman | Executive Vice President |
| William J. Owen* | Senior Vice President, Chief Financial Officer, Treasurer and Assistant Secretary |
| Hyman Lee Jr. | Vice President and Secretary |
| Robert E. Meyer | Senior Vice President and Chief Actuary |

(*) resigned effective June 30, 2006, replaced by Kari L. Van Gundy

Management Agreements

Cost Allocation Agreement: Since 1991, Zenith National Insurance Corp. (Zenith National) and its insurance subsidiaries are parties to a cost allocation agreement with the Company. Under the terms of the agreement, costs of shared facilities, services, and expenses are allocated to each party on a cost allocation basis. During the years 2002, 2003, 2004, and 2005, the Company was paid approximately $3.6 million, $1.4 million, $3.7 million and $7.9 million, respectively. The increase in fees paid during 2005 was reflective of the increase in direct premiums written (and associated costs) by the Company during 2005.

Tax Sharing Agreement: As amended during 1999, the Company and certain affiliates are parties to a tax sharing agreement. The agreement provides for participants to file a consolidated federal income tax return with Zenith National. Allocation of taxes is based upon separate return calculations with inter-company tax balances settled in the quarter subsequent to the filing of the consolidated return.

## TERRITORY AND PLAN OF OPERATION

As of December 31, 2005, the Company was licensed to transact multiple lines of property and casualty insurance in the District of Columbia and the following states:

| | | | | |
|---|---|---|---|---|
| Alabama | Hawaii | Massachusetts | New York | Texas |
| Alaska | Idaho | Michigan | North Carolina | Utah |
| Arizona | Illinois | Minnesota | Ohio | Vermont |
| Arkansas | Indiana | Mississippi | Oklahoma | Virginia |
| California | Iowa | Missouri | Oregon | Washington |
| Colorado | Kansas | Montana | Pennsylvania | Wisconsin |
| Connecticut | Kentucky | Nebraska | Rhode Island | |
| Delaware | Louisiana | Nevada | South Carolina | |
| Florida | Maine | New Jersey | South Dakota | |
| Georgia | Maryland | New Mexico | Tennessee | |

In 2005, the Company wrote approximately $1.1billion of direct premiums. Of the direct premiums written, 67% or $724 million was written in California, 20% or $220 million was written in Florida and the remaining 13% was written in the remaining states.

The principal line of business written is workers' compensation, which amounted to approximately 99% of the Company's total premiums written.

The Company's business is written through approximately 1,404 brokerage firms and independent agencies. The Company maintains branch offices in San Diego, San Francisco, Pleasanton, Sacramento, Fresno, Glendale, and Orange, California. Additionally, the Company maintains branch offices in Austin, Texas; Blue Bell, Pennsylvania; Springfield and Lisle, Illinois; Sarasota, Orlando and Hollywood, Florida; Charlotte, North Carolina and Birmingham, Alabama.

## GROWTH OF COMPANY

The Company reported significant growth in direct and net premiums during the period under examination as follows:

| Year | Direct Premiums Written | Net Premium Written | Surplus |
|---|---|---|---|
| 2005 | $1,081,513,013 | $1,139,993,317 | $440,849,957 |
| 2004 | 1,041,090,077 | 964,825,153 | 573,270,150 |
| 2003 | 767,016,363 | 754,424,915 | 459,804,984 |
| 2002 | 556,638,772 | 568,953,988 | 309,810,235 |

The increase in premiums written during the period under examination was the result of a combination of an increase in the number of policies, an increase in the payroll of the policyholders and rate adjustments implemented during the examination period.

The decline in surplus from 2004 to 2005 was the result of the Company reporting an Excess of Statutory over Statement Reserves in the amount of approximately $240 million as of December 31, 2005 pursuant to California Insurance Code Section 11558.

## REINSURANCE

### Intercompany Pooling Agreement

The underwriting operations of the Company, and its insurance subsidiaries, are governed by an Intercompany Pooling Agreement (Agreement). The Agreement provides for the pooling and distribution, in fixed percentages, of the companies' underwriting operations, liabilities, expenses, income, and losses directly related to the writing of insurance contracts. Excluded from the Agreement are intercompany balances, real estate expenses, investment income and expenses, and directors' fees and similar expenses.

The Company is the lead insurer in the pool. Under the terms of the Agreement, ZNAT Insurance Company (ZNAT) cedes to the Company 100% of its net retained underwriting liabilities. The Company retrocedes to ZNAT a proportionate share of all the underwriting liabilities ceded to the Company. Members of the pool and their respective participation percentages as of year-end 2005 were as follows:

| Pool Member | Percentage |
|---|---|
| Zenith Insurance Company | 98% |
| ZNAT Insurance Company | 2% |
| Total | 100% |

All parties to the Agreement are named participants in all reinsurance agreements with non-affiliated reinsurers, and have a contractual right of direct recovery from the non-affiliated reinsurers.

### Assumed

Assumed business from certain non-affiliates is handled through the Company's Special Situations Division. Treaty reinsurance is assumed on both an excess of loss and quota share basis. This business is written through reinsurance intermediaries and consists primarily of high level excess of loss/catastrophe type coverages on various lines. As of year-end 2005, the Company assumed premiums and known case loss reserves of $78.9 million and $136.8 million, respectively. In September 2005, the Company announced that it would exit the assumed reinsurance business. The majority of the excess of loss reinsurance contracts expired on December 31, 2005 and the remainder will expire by the third quarter of 2006.

Ceded

As of year-end 2005, the Company maintained excess of loss and catastrophe reinsurance protection on its direct workers' compensation writings as follows: Excess of loss reinsurance covering losses, per occurrence, in excess of $1,000,000 up to an aggregate loss of $150 million. The following is a summary of the principal ceded reinsurance treaties inforce as of December 31, 2005:

| Type of Contract | Reinsurer(s) Name | Company's Retention | Reinsurer's Maximum Limits |
|---|---|---|---|
| First – Fourth Layer | 100% Employers Reinsurance Corporation | $1,000,000 | $9,000,000 Excess of $1,000,000 |
| Fifth Layer | 30.36% Various Lloyd's of London Syndicates<br>18% Hannover Rueckversicherungs- AG<br>14.5% XL Reinsurance America Inc,<br>12.5% Endurance Specialty<br>34.64 Various reinsurers | $10,000,000 | $10,000,000 Excess of $10,000,000 |
| Sixth Layer | 12% Hannover Rueckversicherungs- AG<br>12% Swiss Re America Corp.<br>76% Various reinsurers | $20,000,000 | $20,000,000 Excess of $20,000,000 |
| Seventh Layer | 19.60% Various Lloyd's of London Syndicates<br>80.34% Various reinsurers | $40,000,000 | $35,000,000 Excess of $40,000,000 |
| Eighth Layer | 17.70% Employers Reinsurance Corporation<br>15.00% Swiss Re America Corp.<br>13.00% Ace Tempest Reinsurance Limited<br>12.50% Axis Specialty Limited<br>12.50% Endurance Specialty | $75,000,000 | $75,000,000 Excess of $75,000,000 |

As of December 31, 2005, reinsurance recoverables, for all ceded reinsurance totaled $256 million, or 58% of surplus as regards policyholders, with $227 million of the reinsurance recoverables from nonaffiliated admitted reinsurers.

RISCORP, Inc. Acquisition

Pursuant to an Asset Purchase Agreement that was approved by the California Department of Insurance on March 31, 1998, the Company acquired substantially all of the assets and certain liabilities of RISCORP, Inc. (RISCORP) and its subsidiaries related to its workers' compensation business. In connection with the acquisition, the Company entered into an aggregate excess of loss reinsurance agreement with Inter-Ocean Reinsurance Company, Ltd. on August 1, 1998, which provides ceded reinsurance for unpaid loss and loss adjustment expenses assumed from RISCORP at April 1, 1998 up to $50 million in excess of $182 million. The Company paid $15.6 million for the coverage. The agreement has been accounted for as retroactive reinsurance as required under the Statements of Statutory Accounting Practices 62 of the NAIC Accounting Practices and Procedures Manual. As of December 31, 2005 the surplus gain was approximately $12.9 million.

## FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2005

Statement of Financial Condition
as of December 31, 2005

| Assets | Ledger and Nonledger Assets | Assets Not Admitted | Net Admitted Assets | Notes |
|---|---|---|---|---|
| Bonds | $1,067,888,477 | $ | $1,067,888,477 | |
| Preferred stocks | 26,022,965 | | 26,022,965 | |
| Common stocks | 75,705,665 | | 75,705,665 | |
| Real estate occupied by the company | 16,976,986 | | 16,976,986 | |
| Cash and short-term investments | 871,242,341 | | 871,242,341 | |
| Other Invested Assets | 20,198853 | | 20,198,853 | |
| Receivable for securities | 648,250 | | 648,250 | |
| Investment income due and accrued | 13,630,801 | | 13,630,801 | |
| Agents' balances or uncollected premiums: | | | | |
| Premiums and agents' balances in course of collection | 25,440,667 | 1,830,201 | 23,610,466 | |
| Premiums, agents' balances and installments booked but deferred and not yet due | 39,206034 | 1,191,091 | 38,014,943 | |
| Amounts recoverable from reinsurers | 4,635,607 | | 4,635,607 | |
| Funds held by or deposited with reinsured companies | 15,301,440 | | 15,301,440 | |
| Other amounts recoverable under reinsurance contracts | 2,227,897 | | 2,227,897 | |
| Federal income tax recoverable | 1,388,784 | | 1,388,784 | |
| Net deferred tax asset | 75,967,000 | | 75,967,000 | |
| Guarantee funds receivable or on deposit | 14,781,687 | | 14,781,687 | |
| Electronic data processing equipment | 11,460,031 | 5,608,490 | 5,851,541 | |
| Furniture and equipment | 9,059,608 | 9,059,608 | | |
| Receivable from parent, subsidiaries and affiliates | 19,799,618 | | 19,799,618 | |
| Aggregate write-ins for other than invested assets | 15,840,093 | 5,701,039 | 10,139,054 | |
| Total assets | $2,327,422,804 | $ 23,390,429 | $2,304,032,375 | |

Statement of Financial Condition
as of December 31, 2005

(Continued)

Liabilities, Surplus and Other Funds

| | | | |
|---|---|---|---|
| Losses | | $1,172,511,999 | (1) |
| Reinsurance payable on paid losses and loss adjustment expenses | | 2,384,070 | |
| Loss adjustment expenses | | 258,089,066 | (1) |
| Commissions payable | | 13,094,983 | |
| Other expenses | | 8,643377 | |
| Taxes, licenses and fees | | 30,344,256 | |
| Unearned premiums | | 120,971,668 | |
| Advance premiums | | 4,208,372 | |
| Ceded reinsurance premiums payable | | 6,534,753 | |
| Funds held by company under reinsurance treaties | | 12,547 | |
| Amounts withheld or retained by company for account of others | | 4,242,898 | |
| Provision for reinsurance | | 1,816,067 | |
| Aggregate write-ins for liabilities | | 240,328,362 | |
| Total liabilities | | 1,863,182,418 | |
| Aggregate write-ins for special surplus funds | $ 10,526,584 | | |
| Common capital stock | 4,200,000 | | |
| Gross paid-in and contributed surplus | 299,238,109 | | |
| Unassigned funds (surplus) | 126,885,264 | | |
| Surplus as regards policyholders | | 440,849,957 | |
| Total liabilities, surplus and other funds | | $2,304,032,375 | |

## Underwriting and Investment Exhibit
## for the Year Ended December 31, 2005

### Statement of Income

| | | |
|---|---|---|
| Underwriting Income | | |
| Premiums earned | | $1,155,125,985 |
| Deductions: | | |
| Losses incurred | $ 496,960,603 | |
| Loss expense incurred | 192,831,370 | |
| Other underwriting expenses incurred | 295,366,627 | |
| Total underwriting deductions | | 985,158,600 |
| Net underwriting gain | | 169,967,385 |
| Investment Income | | |
| Net investment income earned | $ 76,387,395 | |
| Net realized capital gains | 10,395,896 | |
| Net investment gain | | 86,783,291 |
| Other Income | | |
| Net loss from agents' balances charged off | $ (3,655,939) | |
| Aggregate write-ins for miscellaneous income | 32,941 | |
| Total other loss | | (3,622,998) |
| Net income before dividends to policyholders and before federal income taxes | | 253,127,678 |
| Dividends to policyholders | | 3,913,940 |
| Federal income taxes incurred | | 89,954,000 |
| Net income | | $159,259,738 |

### Capital and Surplus Account

| | | |
|---|---|---|
| Surplus as regards policyholders, December 31, 2004 | | $ 573,270,151 |
| Net income | $159,259,738 | |
| Change in net unrealized capital losses | (29,048,867) | |
| Change in net unrealized foreign exchange capital loss | (3,587,584) | |
| Change in deferred income tax | 14,407,497 | |
| Change in nonadmitted assets | (3,612,031) | |
| Change in provision for reinsurance | 6,052,655 | |
| Dividends to stockholders | (30,000,000) | |
| Aggregate write-ins for gains and losses in surplus | (245,891,604) | |
| Change in surplus as regards policyholders | | (132,420,194) |
| Surplus as regards policyholders, December 31, 2005 | | $440,849,957 |

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2005

| | | | |
|---|---|---|---|
| Surplus as regards policyholders, December 31, 2001, per Examination | | | $162,584,794 |
| | Gain in Surplus | Loss in Surplus | |
| Net income | $448,480,598 | $ | |
| Net unrealized capital gains | 7,936,016 | | |
| Change in unrealized foreign exchange capital gain | 4,118,087 | | |
| Change in deferred income tax | 8,764,499 | | |
| Change in nonadmitted assets | 31,479,997 | | |
| Change in provision for reinsurance | 4,379,618 | | |
| Surplus adjustments: Paid-in | 92,462,890 | | |
| Dividends to stockholders | | 60,000,000 | |
| Aggregate write-ins for losses in surplus | | 259,356,542 | |
| Totals | $ 597,621,705 | $ 319,356,542 | |
| Net increase in surplus as regards policyholders for the examination | | | 278,265,163 |
| Surplus as regards policyholders, December 31, 2005, per Examination | | | $ 440,849,957 |

## COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based upon a review conducted by a Casualty Actuary from the California Department of Insurance, the Company's reserves for losses and loss adjustment expenses as of December 31, 2005, after consideration of the reserve established pursuant to California Insurance Code (CIC) Section 11558, were found to be reasonably stated.

## SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

None.

Previous Report of Examination

Losses and Loss Adjustment Expenses (Page 15): It was recommended that the Company review its methods for allocating loss adjustment, other underwriting and investment expenses when preparing the Underwriting and Investment Exhibit (Part 4) of the Annual Statement. The examiners reviewed the methods for allocating loss adjustment, other underwriting and investment expenses and it appears that the expenses are properly allocated.

# ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

/S/

Constance J. Korte, CFE
Examiner-In-Charge
Department of Insurance
State of California